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before

House Subcommittee on Commerce, Trade, and Consumer Protection
Committee on Energy and Commerce
U.S. House of Representatives
July 11, 2006

Chairman Sterns, Ranking Member Schakowsky, thank you for the opportunity to participate in this hearing on H.R. 5337, the “Reform of National Security Reviews of Foreign Direct Investments Act.” H.R. 5337 would establish in statute the Committee on Foreign Investment in the United States and establish procedures “to ensure national security while promoting foreign investment.” In my remarks, I want to make clear that I am speaking for myself; the Council on Foreign Relations is a non-partisan think tank that does not take positions on issues.

The Economic and Global Power of the United States

Among developed economies, the United States has performed uniquely well in the past decade. The key characteristic of this outstanding growth has been a post-1995 acceleration in U.S. productivity – that summary measure indicates the ability of an economy to produce the same goods more cheaply, generate a greater standard of living than in the past from the same people, factories, and equipment, and to use innovation to produce different and higher-quality goods than in the past. In short, productivity is the single-best summary measure of the overall long-term performance of an economy and the United States stands out in recent years.

One ingredient in this recipe for success has been openness to global trade in goods, services, and capital. There is a growing body of economic research that documents the beneficial dynamics of open trade. For example, those firms that are engaged in global markets are more productive than their domestically-oriented counterparts.

An example of the dynamic benefits of open trade is in information technology hardware. As noted, the United States experienced a surge in productivity growth after 1995 (and perhaps again recently). A substantial factor was the increasing sophistication of IT hardware. One version of this story credits clever engineers in the selfless pursuit of Moore’s law. But it is also the case that IT hardware is among the most global and competitive industries, and global markets reward entrepreneurial zeal as much as engineering skills. Moreover, policy supported these dynamics. The Declaration on Trade in Information Technology Products (ITA) from the 1996 Singapore Ministerial Conference was the foundation for reduced barriers to trade in IT hardware.

A related strength of the United States is its sophisticated, deep, and specialized financial markets. Financial markets are the central nervous system of a market economy, serving to collect and transmit important information, guide capital to its most productive use, and enhance the overall coordination of firms, households, and governments.

One particular aspect of executing these functions is financing mergers and acquisitions (M&A). These transactions generate economic value. The bids by new owners raise the overall return to existing shareholders, generating additional capital market funds. At the same time, new ownership can bid more as a result of replacing ineffective management, taking advantage of beneficial complementarities (“synergies”) with their existing business model, or otherwise raising the productivity of the purchased firms’ capital, technologies, and labor skills. In short, the new firm is more productive than the old – in this way, mergers and acquisitions are one manifestation of the role of competitive financial markets in efficiently allocating national capital.

As capital markets have become global in scope, so has M&A (along with “greenfield” investments by U.S. firms abroad and overseas investors in the United States). Currently, U.S. subsidiaries of companies based outside the United States have over 5 million employees and pay compensation of over \$300 billion each year, or about \$60,000 per employee. The vast bulk of these investments have come from countries belonging to the Organization for Economic Cooperation and Development (OECD, over 90 percent) and a small minority is undertaken by firms with government control (2 percent).

In short, a strong economy is part of national security and open, global capital markets are a cornerstone of our strong economic future. Nevertheless, despite the fact that few cross-border transactions show risk of affecting security directly and few are undertaken by firms with government control, those situations do arise (and have arisen) in which security considerations overwhelm the financial desirability of a particular transaction. Thus, to meet overall objectives, it is essential to pair policies that support well-functioning, open capital markets with specific carve-outs for transactions that pose a security threat.

Reform of CFIUS

The topic of today’s hearing is reform of the Committee on Foreign Investment in the United States (CFIUS) and the process by which it accomplishes these needed carve-outs. As the Congress considers revisions to the CFIUS process, it is important to recognize that the current system has served the United States very well. To date, CFIUS has to a great extent simultaneously supported national security and economic growth. Thus, there would appear to be little merit in a wholesale rethinking of the CFIUS process. Nevertheless, some improvements are possible; by what criteria should proposed changes be judged?

A Targeted Process. First, CFIUS should be a targeted process to identify those transactions that generate a legitimate national security concern without excessive and wasteful scrutiny of routine transactions.

An important aspect of achieving this objective is preserving the voluntary nature of CFIUS filings. At present, participants to transactions have excellent incentives to seek CFIUS clearance: a safe harbor from future security scrutiny, mitigation or divestiture. This system avoids wasteful reviews of routine transactions and targets CFIUS efforts on achieving satisfactory reviews and investigations of problematic transactions. H.R. 5337 preserves this system.

Predictability. Second, the CFIUS process should be predictable. That is, it would be transparent to market participants which transactions would merit scrutiny and review and how the security impact of the transaction would be evaluated.

H.R. 5337 makes some improvements to the CFIUS process in this regard. It clarifies the “rules of the road” by making clear that if a transaction involves a foreign-government controlled firm, the transaction must be subjected to the investigation process. In addition, an investigation period may be extended by two-thirds vote of CFIUS, requires the signature of the Chair and Vice-Chair on decisions, and provides support for CFIUS by other agencies.

The transparency of the process is improved by designating in statute CFIUS member agencies and improving the nature and regularity of reporting to Congress. One issue that arises in this regard is the organization of CFIUS in H.R. 5337, particularly the designation of Treasury as the Chair and Homeland Security as the Vice-Chair.

With regard to the former, the contention is sometimes made that a “security” agency should lead CFIUS; a reciprocal concern being that with Treasury as the Chair the process may have a commercial bias at the expense of national security. This concern strikes me as misplaced. Treasury is a member of the National Security Council, takes a lead role in the battle against terrorism, and otherwise has functions that mirror those of traditional security agencies. Moreover, in practice the role of the CFIUS Chair has largely been organizational and not operational. To the extent that Congress chose not to designate Treasury as Chair, it may be desirable to rotate the convening power among selected agencies. This strikes me as having a small cost in transparency, but one that Congress may deem to be acceptable.

H.R. 5337 also designates Homeland Security to be the Vice-Chair of CFIUS, which raises the larger issue of the role of homeland security in national security reviews. A danger is setting a standard for national security that is either overly broad or indistinct. For example, drawing into the standard “critical infrastructure” as embodied in homeland security objectives could potentially include all transactions in the food supply chain. Similarly, definitions that include “economic security” are too broad and likely to generate uncertainty regarding investments. H.R. 5337 requires CFIUS to consider whether a transaction has a security-related impact on critical infrastructure, a specification that retains the correct focus – *a security-related impact*, not critical infrastructure *per se*.

Put differently, I believe that homeland security should be seen as an integral part of the traditional focus on national security and not as a separate, new, or elevated consideration. From this perspective, the Department of Homeland Security has operational roles that contribute to national security. The Congress may wish to consider whether those roles are sufficiently broad and important to designate Homeland Security as the standing Vice-Chair of CFIUS.

Confidentiality. A third criterion is that process would provide a high degree of confidentiality to secure proprietary business information and national security considerations. H.R. 5337 seeks an appropriate balance between the duty for congressional oversight and the importance of confidentiality and streamlined transactions.

Flexibility. Fourth, the process should be flexible, providing arrangements that permit means to augment security or otherwise satisfy these criteria as part of the transaction itself. H.R. 5337 retains such flexibility by permitting CFIUS to negotiate mitigation agreements flexibly with firms involved in a covered transaction. The bill also makes improvements that may serve to build expertise and continuity of staff in this important area, by establishing tracking compliance with mitigation agreements that will accumulate knowledge of successful and unsuccessful approaches and by directing \$10 million to CFIUS in the next few years. This may prove crucial as press reports indicate that the fraction of Treasury time and personnel devoted to the CFIUS process has risen dramatically recently.

Timeliness. The final criterion is that the CFIUS process should be as timely as possible. Many observers have expressed support for the current timetables, particularly the ability to coordinate with (Hart-Scott-Rodino) anti-trust reviews. H.R. 5337 retains the 30-day review period, but also properly draws into the CFIUS process information from the Director of National Intelligence. It also mandates a 45-day investigation for all foreign-government controlled transactions, regardless of whether a genuine security risk is present. These features may require more time, but it is desirable to keep mandated extensions to the existing timetables a limited as possible.

Larger Issues

Looking past narrow evaluation of H.R. 5337, the topic of CFIUS reform legislation raises the potential for concern. Over time, administrations of both political parties have helped to establish a global rules-based system for open investment and free trade. This approach has supported U.S. economic success. This success is put at risk if new procedures are unclear, viewed as overly politicized or unnecessarily discriminate against foreign investment. Procedures of this sort would in themselves worsen the favorable investment climate. An even more problematic outcome would occur if other countries chose policies that provided reciprocal discriminatory treatment against U.S. firms.

In this regard, three areas merit attention. First, it is useful to retain a targeted and clear definition of those transactions covered by CFIUS, and to focus on operational control of

new technologies or sensitive locations. As noted earlier, definitions that include more vague references to “economic security” or those that include an overly-inclusive concept of “critical infrastructure” would likely be detrimental.

Second, it is useful to keep review and investigation times to the minimum necessary to determine the evidence of a genuine national security threat.

Third, it is important to avoid introducing overt political considerations into the process. Indeed, a threshold consideration is the degree to which it is desirable to legislate aspects of the policy at all. CFIUS has been successful in part because it was appropriately an administrative procedure. The greater the extent of legislated review, report, or decision-making, the greater the possibility of detrimental consequences. H.R. 5337 contains detailed reporting requirements on both specific covered transactions and CFIUS reviews in general. While not troubling, a further extension of these provisions raises concerns over politicization and confidentiality.

Any lingering perception of politically-driven reviews raises the danger that other countries will use recent events in the United States as pretext for protectionist rules draped in the guise of national security. For example, press reports indicate that China will tighten screening of deals and impose new curbs on foreign acquisitions – setting up a ministry-level committee to review controlling stakes in strategic industries including steel and the manufacturing of equipment for shipbuilding and power generation. Any broader, global trend of this type would directly hurt U.S. investments abroad.

Conclusion

Mr. Chairman, as CFIUS reform is considered by Congress, it is important to recognize that it is possible to provide open global markets, strong economic growth, and national security. For the most part, these go hand in hand. For example, the Congressional Budget Office projects that over the next decade and one-half, current defense plans will require spending an average of \$500 billion (adjusted for inflation), a peak increase of roughly 20 percent over current levels (adjusted for inflation) and above the peak of Cold War spending. Despite this rise, these plans would result in defense spending constituting less than 2.5 percent of Gross Domestic Product, well below the postwar peak of 9.5 percent in 1968.¹ A key aspect of national security is an economy that grows strongly enough to continue to meet the resource demands in the private sector, social objectives, and our military and other national security needs.

In those narrow areas where potential tradeoffs between economic growth and national security arise, a transparent, targeted, disciplined, and confidential process to augment economic transactions with security dimensions will serve the United States well.

Thank you for the opportunity to appear before the Subcommittee. I look forward to your questions.

¹ See *The Long-Term Implications of Current Defense Plans and Alternatives: Summary Update for Fiscal Year 2006*, Congressional Budget Office, 2005.